Disclosure Guidelines for Financial Reporting by Microfinance Institutions

January 2001 provisional version, pending results of field testing

Consultative Group to Assist the Poorest
Washington, D.C.

The guidelines in this manual were developed in consultation with microfinance practitioners and CGAP's member donors. In June 2000 the member donors approved distribution of this preliminary version of the guidelines. After field testing in early 2001, a final version of the guidelines will be issued.

CGAP is composed of bilateral foreign aid agencies from 16 countries:

Australia	Finland	Japan	Sweden
Belgium	France	Luxembourg	Switzerland
Canada	Germany	Netherlands	United Kingdom
Denmark	Italy	Norway	United States

and 12 multilateral agencies:

African Development Bank
Asian Development Bank
European Bank for Reconstruction and Development
European Commission
Inter-American Development Bank
International Finance Corporation
International Fund for Agricultural Development
International Labour Organization
United Nations Capital Development Fund
United Nations Conference on Trade and Development
United Nations Development Programme
World Bank

If you use these guidelines in preparing audited or unaudited financial statements any time before 31 July 2001, please consider sending CGAP a copy of those statements, along with comments about your experience in applying the guidelines. (A form for this purpose is provided at the end of this manual.) We guarantee the confidentiality of your financial statements. They will be seen only by the staff validating the guidelines, and will then be destroyed.

Contents

About the Guidelines

Format of this manual

Guidelines are printed on even-numbered pages. Examples, for illustration only, are printed on odd-numbered pages. Terms preceded by "➤" are defined in the glossary (annex A).

Why are these guidelines needed?

Donors, other investors, board members, and managers of microfinance institutions (MFIs) rely on an MFI's ➤*financial statements* when they assess its financial sustainability and loan portfolio. But many financial statements do not include enough information to permit such an assessment.

To help address this problem, the donors who make up the Consultative Group to Assist the Poorest (CGAP) have developed these guidelines specifying information that should be included in MFI financial reporting.

The guidelines are not accounting standards

It must be emphasized that these are only disclosure guidelines. They call for the reporting of certain information, including the accounting method used in deriving that information, but they do not direct the choice of accounting method. (Authoritative guidance on accounting standards can be found in *International Accounting Standards* and publications of national accounting standards boards.) For instance, these guidelines require an MFI to report the amount of its ➤*loan loss reserve* as well as the method used in determining that amount. But they do not require the use of one particular method in determining the reserve.

The guidelines do not require any particular ➤*chart of accounts* or reporting format

The guidelines are satisfied if the required information is included, regardless of the format or order in which this information is presented. Any chart of accounts or style of presentation can be used as along as the required information is clearly included somewhere. *Thus the examples provided are simply illustrations of one possible way to present the information: there is no requirement to use the format shown in any example.* (In particular, the disclosure guidelines take no position on whether certain information should be included in the main body of financial statements or in the notes to those statements.) Experience has shown that this caution is often not understood, so it is repeated on each example page.

Consequently, these guidelines can be used in any country, regardless of its accounting standards and methods of financial presentation.

The guidelines require some information not normally found in financial statements

Most MFIs are unusual institutions: they use a financial business to pursue a social mission that is often supported—at least temporarily—by grants or ➤*soft loans.* In addition, MFIs tend to use loan methods that are much different from those used by conventional banks. Because of these special characteristics, judging an MFI's financial condition requires some information that conventional businesses do not report—such as information about ➤*in-kind subsidies,* the ➤*delinquency* status of the ➤*loan portfolio,* or other items not required under International Accounting Standards (IAS).

The guidelines below are followed by text that briefly explains why the required information is important. Far more detailed discussions can be found in manuals for financial analysis of MFIs.[1]

Relationship between guidelines and external audits

Annual external audits of MFIs' financial statements are strongly recommended, and are usually required by funders. But even where financial statements are not audited, these disclosure guidelines are intended to apply if financial statements are being used to present an MFI's financial condition to outsiders such as donors or investors. Boards of directors and managers can decide which of the guidelines to apply in financial statements prepared for internal use.

Whenever these guidelines are incorporated in the terms of reference for an external audit, the auditor should be required to include a clear statement in the ➤*opinion letter* to the effect that the audited financial statements:

1. Useful reference materials include Inter-American Development Bank, 1994, *Technical Guide for the Analysis of Microenterprise Finance Institutions,* Washington, D.C. (also available in Spanish); Martin Holtman and Rochus Mommartz, 1996, *Technical Guide for Analyzing the Efficiency of Credit-Granting Non-Governmental Organizations (NGOs),* Saarbrücken; Small Enterprise Education and Promotion Network (SEEP), 1995, *Financial Ratio Analysis of Micro-Finance Institutions,* Pact Publications, New York; Robert Peck Christen, Brigit Helms, and Richard Rosenberg, 1999, *Format for Appraisal of Microfinance Institutions,* CGAP Technical Tool Series 4, Washington, D.C.; and Robert Peck Christen, 1997, *Banking Services for the Poor: An Expanded and Revised Guidebook for Microfinance Institutions,* ACCIÓN International, Cambridge, Mass.

- *Comply fully* with the guidelines (example A);[2]
- *Comply substantially* with the guidelines, with relatively minor deviations (example B); or
- *Do not comply* with the guidelines (example C).

In any case where there is less than full compliance, the auditor should be required to explain somewhere in the audit report the nature of each deviation from the guidelines and management's reason for not complying. The opinion letter should also describe the CGAP guidelines, stating that they are voluntary norms, not official accounting or audit standards—especially in cases where less than full compliance is reported.

When unaudited financial statements are presented to outside parties, an MFI's board of directors or management is encouraged to include a similar statement on whether the reporting conforms to the guidelines.

Which parts of this manual are mandatory?

A financial report complies with these guidelines only if it conforms to the "black letter" rules at the beginning of each section that follows (see also annex B) and to any more detailed requirements in the text. As noted, the examples on odd-numbered pages are illustrative only and so are not part of the guidelines.

2. Guideline 6.5 (on cumulative donations) is optional. Thus an MFI can be in full compliance without providing the information discussed in that guideline.

Examples

Example A: auditor's opinion letter (relationship between guidelines and external audits)

"The terms of reference for this audit call for the auditor to express a conclusion as to whether the financial statements comply with CGAP's *Disclosure Guidelines for Financial Reporting by Microfinance Institutions.* These guidelines are voluntary norms recommended by a consultative group of international donors. Thus an institution's failure to comply with the CGAP guidelines would not necessarily imply that the institution or its financial statements are in violation of any legal or other authoritative accounting or reporting standard.

We conclude that the financial statements herein with accompanying notes comply with the CGAP guidelines in all material respects."

Example B: auditor's opinion letter (relationship between guidelines and external audits)

"We conclude that the financial statements herein with accompanying notes comply substantially with the CGAP guidelines, apart from the following exception:

The MFI has a small social training program but has not presented an unconsolidated income statement segregating the income and expenses of its financial service operation, as required by CGAP guideline 3.1. Management's explanation is that it is unable to perform the necessary cost allocations."

Example C: auditor's opinion letter (relationship between guidelines and external audits)

"We conclude that the financial statements herein fail to comply with the CGAP guidelines:

- Provisioning policy is not explained (CGAP guidelines 4.1 and 4.2).
- The statements include no portfolio report showing the extent of late payment (CGAP guideline 5.1).
- The value of in-kind donations is not disclosed (CGAP guideline 6.4).

Management has provided no explanation for these omissions."

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

1 Financial Statements

1.1 At a minimum, MFI financial statements should include both a ➤*balance sheet* and an ➤*income (profit and loss) statement,* with accompanying notes.

This guideline is less stringent than International Accounting Standards, which also require a ➤*cash-flow statement* (sources and uses of funds).

Examples

Several examples of balance sheets (or statements of affairs) and income statements (or profit and loss accounts, or statements of surplus and deficit) appear on the following pages.

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

2 Information from Past Years

2.1 Statements should show financial information for both the current year and at least the previous year, and include a comment on any unusual movements.

Presenting multiple years of information together permits an understanding of trends. Including more than two years can be useful but is not required for compliance with these guidelines. If a change in some material account appears to be unusual or worrisome, a description of the reason for the change helps in assessing the MFI's future prospects.

Example 2.1: Current and prior years' information

BALANCE SHEET AS OF 31 DECEMBER

	1999	1998
Assets		
Cash and deposits	2,238,411	1,293,092
Loans outstanding	1,840,551	1,879,730
Loan loss reserve	(34,419)	(39,786)
Net loans outstanding	1,806,132	1,839,944
Net fixed assets	1,467,301	1,237,624
Total assets	5,511,844	4,370,660
Liabilities and equity		
Current liabilities	1,489,003	1,050,338
Non-current liabilities	2,121,262	907,241
Equity	1,901,579	2,413,081
Total liabilities and equity	5,511,844	4,370,660

INCOME STATEMENT FOR 1 JANUARY TO 31 DECEMBER

	Note	1999	1998
Financial income		1,867,018	1,276,416
Financial expenses		273,111	164,927
Loans written off		1,219,835	
Administrative expenses	1	1,243,593	1,055,441
Total operating expenses		2,736,539	1,220,368
Net profit/(loss) from operations		(869,521)	56,048
Non-operating income and expenses			
Grants and donations		400,000	789,994
Other non-operating income and (expenses)		(41,981)	
Total profit/(loss)		(511,502)	846,042

Note 1: unusual movements

Management wrote off an unprecedented amount of loans after the disintegration of one branch office following political turmoil that resulted in clients migrating to areas outside the region of operations. Management subsequently closed the branch office.

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

3 ➤*Segment Reporting* for Multiservice Microfinance Institutions

3.1 An MFI that offers both financial and nonfinancial services should provide a separate income statement for the financial service business (in addition to a consolidated income statement and balance sheet for the institution as a whole).

In addition to financial services, many MFIs provide nonfinancial services—such as training, production or marketing assistance, health care, or community development—that are not essential to the delivery of their financial services. These MFIs may not fully segregate the accounting and administration of these different services.[3] But it is impossible to determine the sustainability of microfinance operations unless their financial results are presented separately from those of other operations. (The same principles would apply to a commercial bank wanting to report separately on the activities of its microfinance division. In such cases it is generally highly desirable for any presentation of financial results of microfinance to include segment reporting on the microfinance component as well as financial statements for the bank as a whole.)

3.2 There should be a clear explanation of the methods used to allocate shared costs or revenues between financial and nonfinancial services.

Dividing ➤*operational income* between financial and nonfinancial services is usually straightforward. Allocating expenses can be more difficult because many costs are shared between the two types of services—such as certain office costs or the time of the executive director and other staff that deal with both services. Some reasonable allocation formula needs to be determined.[4]

3. Some MFIs take the position that the nonfinancial services they provide are an essential part of their methodology for delivering financial services. For instance, they might believe that business training for their clients is crucial to the clients' ability to repay their loans. In such cases segment reporting is not meaningful and so is not required.
4. See CGAP, "Cost Allocation for Multi-Service Micro-Finance Institutions," Occasional Paper 2, which is available on the CGAP Website (*http://www.cgap.org*) or from CGAP, 1818 H Street NW, Room Q4-400, Washington, D.C. 20433, USA.

Example 3.1: Separate income statement for financial services

INCOME STATEMENT FOR 1 JANUARY TO 31 DECEMBER 1999

	Financial services	Training services	Consolidated total
Income			
Interest and fees on loans	1,811,925		1,811,925
Interest from investments	55,093		55,093
Training income		46,590	46,590
Total income	1,867,018	46,590	1,913,608
Operating expenses			
Interest on debt	203,247		203,247
Interest on deposits	19,103		19,103
Provision for loan losses	50,761		50,761
Administrative expenses			
Personnel expenses	667,535	57,198	724,733
Other administrative expenses	487,487	31,373	518,860
Total operating expenses	1,428,133	88,571	1,516,704
Net operating profit/(loss)	438,885	(41,981)	396,904
Non-operating income			
Grants and donations	360,000	40,000	400,000
Total profit/(loss)	798,885	(1,981)	796,904

[The same information is presented for 1998.]

Example 3.2: Expense allocation for segment reporting

The MFI allocates expenses between its financial and training services on the following basis:

- Personnel expenses: allocates to the training program the full cost of two staff members who run the program full-time. Allocates the cost of three staff members who split time between the training program and the credit program based on monthly timesheets.
- Other shared administrative expenses: allocates indirect expenses between financial and training services in proportion to the direct administrative expenses of those services.
- Grants and donations: allocates based on the agreement with the donor.

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

3.3 There should be a clear identification of which accounts in the balance sheet of a multiservice MFI are tied to microfinance services.

Segmented balance sheets—as opposed to income statements—may be desirable in some situations, but they are not required by these guidelines. A segmented balance sheet requires allocation by formula of some items, such as fixed assets and capital accounts. Other balance sheet accounts are more clearly identified with microfinance operations—for instance, loans to clients, loan loss reserves, and liabilities used to fund loan programs.

Even if a segmented balance sheet is not provided, the financial report should indicate which balance sheet accounts are completely or almost completely tied to microfinance services.

Example 3.3: Balance sheet accounts related to microfinance services

The following accounts are completely or almost completely tied to microfinance services:
- Assets: loan portfolio, short-term deposits, and other current assets.
- Liabilities: deposits, short-term debt, and long-term debt.

The following accounts have significant amounts tied to microfinance services:
- Long-term investments: about 60 percent of long-term investments are in membership shares in an apex organization from which the MFI can obtain debt funding, training, and technical assistance for financial services. The remaining investments are long-term deposits of donor funding for training.
- Fixed assets: financial services account for about 80 percent of the use of the MFI's fixed assets.

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

4 Microloan Portfolio Accounting Issues

4.1 Expenses related to actual or anticipated loan losses should be shown separately from other expenses in the income statement. The accounting policy underlying the recognition and amount of such loan loss expenses should be clearly described.[5]

4.2 The amount of the loan loss reserve should be shown, usually as a negative asset deducted from the loan portfolio or as a reserve in the capital account. The accounting policy underlying the determination of this reserve should be clearly described.

A provision expense for likely loan losses is important because without it the income statement will underestimate the true costs of the MFI's business—overestimating profitability. Similarly, unless there is a reserve for loans that are likely to become uncollectable, the balance sheet will overstate the true value of the portfolio and the MFI's net worth. Even when an MFI's income statement fails to recognize loan loss expense, or when the MFI has no loan loss reserve, a line for these items (showing zero) should be included.

The loan portfolio is usually an MFI's biggest asset, and nonpayment of loans is typically the most dangerous business risk inherent in microfinance. Clear reporting in this area is crucial, especially since MFIs tend to underestimate eventual loan losses. The reasonableness of provisions and reserves depends on how they are determined. Thus readers of an MFI's financial statement can make no solid judgment about the institution's real profitability or the real value of its assets unless its methods for determining the ➤*loan loss provision expense* and loan loss reserve are reported clearly and in sufficient detail. The financial report should go beyond general statements such as "provision expense is recognized in an amount necessary to bring the loan loss reserve up to an appropriate level." If an MFI has no defined policy on these matters, this situation must be explicitly reported.

5. The use of terms like *provision, reserve,* and *allowance* in connection with loan losses is not standardized and can be confusing. In these guidelines *loan loss expense* and *loan loss provision expense* refer to an income statement account reflecting the cost of actual or anticipated failure to collect loan principal. *Loan loss reserve* refers to a balance sheet account (usually a negative asset deducted from the loan portfolio or a reserve in the capital account) that compensates for expected future loan losses.

Example 4.1–4.4 (A): Loan loss provision expenses, loan loss reserve, write-offs, reconciliation

INCOME STATEMENT AS OF 31 DECEMBER

	Note	1999	1998
Financial income		43,594,899	28,655,989
Financial expenses		(4,239,558)	(2,874,982)
Gross financial margin		39,355,341	25,781,007
Provision for doubtful loans	4	(2,795,563)	(998,641)
Gross operating margin		36,559,778	24,782,366
Administrative expenses		(23,426,915)	(15,543,754)
Net profit from operations		13,132,863	9,238,611
Non-operational income		4,102,821	5,349,091
Net profit for the year		17,235,684	14,587,702

Note 4: loan loss provision, reserve, and write-off policy
The MFI sets a loan loss reserve of 3 percent of the outstanding loan portfolio. This percentage is not based on the historical performance of the loan portfolio. At the end of each fiscal year, the MFI computes a provision for doubtful debts based on the amount required to maintain a loan loss reserve after writing off 3 percent of the outstanding loan portfolio. In the middle and at the end of each fiscal year, management writes off all loans with overdue payments older than 180 days from the date the first missed installment fell due. The following schedule reconciles loan loss provisions, reserves, and write-offs.

MOVEMENTS IN LOAN LOSS RESERVES

	1999	1998
Loan loss reserve, 1 January	1,839,902	1,217,020
Loan loss provision expense for the year	2,795,563	998,641
Loans written off during the year (net of recoveries)	(559,749)	(375,759)
Loan loss reserve, 31 December (3% of loan portfolio)	4,075,716	1,839,902

OUTSTANDING LOAN PORTFOLIO (PRINCIPAL)

	1999	1998
Current loans	130,552,985	59,268,628
Loans overdue less than 181 days	5,304,210	2,061,443
Total loan portfolio	135,857,195	61,330,071
Loan loss reserve	(4,075,716)	(1,839,902)
Net loan portfolio	131,781,479	59,490,169

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

4.3 The amount of loans ➤*written off* during the period must be shown. The policy governing the amount written off should be stated clearly and in detail, including how other accounts are affected by the write-off.

When the probability of collecting a loan becomes very low, normal practice is to charge the loan off by deducting its value from the loan portfolio, balanced by reducing the loan loss reserve or, if there is no reserve, by charging an equivalent expense to the income statement. The apparent gross value of an MFI's loan portfolio and the apparent quality of its repayment performance are directly affected by management decisions about how and when to write off loans. Thus the financial report must clearly describe the policy governing write-offs, whether or not that policy is written. In particular, the description must be explicit about when a loan is first considered late (after the first missed payment? after 90 days of missed payments? after the loan term has expired?); how long it takes, once a loan has been defined as late, for it to enter write-off status; and at what points during the reporting period write-offs are actually carried out.

4.4 The financial presentation should include a table that reconciles the accounts affecting the loan portfolio, including:

- **Loan loss reserves at the beginning and end of the period.**
- **Loan loss provision expenses recognized during the period.**
- **Write-offs of uncollectable loans.**

Example 4.1–4.4 (B): Loan loss provision, reserve, and write-off policy

Management provisions for loan losses every quarter to maintain an adequate reserve for doubtful loans. The reserve is determined by applying predicted loss percentages to aged loans grouped by lateness of payments. A loan becomes late as soon as a scheduled installment is missed. The predicted loss percentages are based on management's analysis of historical outcomes of late loans. The loan loss reserve as of 31 December 1999 is as follows:

LOAN LOSS RESERVE COMPUTATION

	Outstanding loan portfolio (principal)		Loss reserve	
	Share of total	**Amount**	**Percent**	**Amount**
Normal loans				
Current	95.2%	1,850,924	1%	18,509
1–30 days late	2.1%	40,713	25%	10,178
31–90 days late	1.4%	26,967	50%	13,484
More than 90 days late	0.7%	14,026	100%	14,026
Renegotiated loans				
Current and up to 30 days late	0.4%	8,645	25%	2,161
More than 30 days late	0.1%	2,110	100%	2,110
Total	100%	1,943,385		60,468

At the end of each fiscal year management reviews all loans more than 90 days late and writes off, on a case-by-case basis, those with no realistic prospects of recovery. Write-offs are taken out of the outstanding loan portfolio and deducted from the loan loss reserve.

The following schedule reconciles loan loss provisions, reserves, and write-offs:

MOVEMENTS IN LOAN LOSS RESERVES	**1999**	**1998**
Loan loss reserve, 1 January	37,946	8,234
Loan loss provision expense for the year	28,006	35,573
Loans written off during the year (net of recoveries)	(5,484)	(25,861)
Loan loss reserve, 31 December	60,468	37,946

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

4.5 If an MFI accrues unpaid interest on late loans, there should be a clear and thorough explanation of its policies on this matter—especially the point at which further accrual of unpaid interest is stopped and previous accruals are reversed out of income.

Many financial institutions continue to recognize interest income on a loan as it comes due even when the interest has not been received because payment is late. There is a tendency to continue this accrual past the point where the collection of the interest becomes doubtful. Thus it is important to disclose the policies behind such accrual.

Example 4.1–4.4 (C): Loan loss provision, reserve, and write-off policy

At the end of each fiscal year management reviews all loans more than 180 days late from the date of the final installment on the loan schedule. Management makes case-by-case decisions on whether to write off loans, depending on whether reasonable efforts at collection appear to have failed. Loans are written off by deducting the outstanding principal balance from the loan portfolio and charging a loan loss account in the income statement. During 1998 management wrote off loans totaling 8,443, and in 1999 it wrote off loans totaling 13,763.

Example 4.1–4.4 (D): Loan loss provision, reserve, and write-off policy

The MFI does not provision for bad loans and does not write off any loans.

Example 4.5: Interest accrual on late loans

Interest income on loans is collected with monthly loan repayments. Due but unpaid interest is accrued on late loans for up to 90 days. After 90 days, late loans are classified as nonperforming and further accrual of unpaid interest income ceases. Accrued interest on nonperforming loans, including written-off loans, is reversed out of income on an ongoing basis. Accrued interest was 4,912 on 31 December 1999 and 3,034 on 31 December 1998.

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

5 Portfolio Quality and Management

5.1 A portfolio report should show the extent of late payment on loans as of the end of the current reporting period, and any measurement of late payment should be thoroughly explained—including precise definitions of the numerator and the denominator of any ratio measuring loan portfolio quality.

The degree of delinquency in a portfolio is usually the strongest predictor of whether loans will be repaid. Thus the level of delinquency is an important factor in setting appropriate loan loss reserves. Conventional financial statements usually do not include a delinquency report. Nevertheless, a delinquency report is crucial in assessing the financial health of an MFI. Because most MFIs are not subject to banking regulation, they are not bound by external rules in setting their loan loss reserves.

The core of a delinquency report is usually a ratio or ratios that summarize the condition of the portfolio. A ratio is a percentage resulting when one measured number (the numerator of the fraction) is divided by another (the denominator). Many different ratios are used. Interpreting a reported ratio is impossible unless the report is extremely clear about what is being measured in both the numerator and the denominator of the ratio fraction. At a minimum the portfolio report required by these guidelines must contain one or more of the ratios calculated by the MFI to measure its portfolio delinquency, along with a precise explanation of what is being measured.[6] If the MFI does not track or measure the delinquency status of its portfolio, that fact should be explicitly stated.

Most ratios used to measure loan delinquency fall into one of three categories:

- Portfolio at risk measures—where the numerator is the ➤*outstanding* balance of loans that are at higher risk because a payment is late by a specified number of days and the denominator is the outstanding balance for the entire portfolio. Alternatively, the numerator is the number of outstanding loans that are late and the denominator is the total number of outstanding loans. Example A illustrates an aged portfolio at risk report, which is considered the international standard for portfolio reporting and is strongly recommended for MFIs.
- Collection or repayment rates—where the numerator is payments received and the denominator is payments due.
- Arrears rates—where the numerator is late payments and the denominator is some measure of the total portfolio.

For any variable involving the concept of lateness, the report should be precise and unambiguous about the value being measured and the point at which the loan is first

6. For a detailed discussion of delinquency measures and their interpretation, see Richard Rosenberg, 1999, "Measuring Microcredit Delinquency: Ratios Can be Harmful to Your Health," CGAP Occasional Paper 3, Washington, D.C.

Example 5.1 (A): Portfolio quality

The MFI's main measure of loan delinquency is an aged portfolio at risk ratio. Loans are separated into classes depending on how many days overdue they are. For each class of loans, the outstanding principal balance of such loans is divided by the outstanding principal balance of the gross loan portfolio (that is, with no deduction for loan loss reserves). Loans are considered overdue if a payment has fallen due and remained unpaid. Loan payments are applied first to any interest due, then to any installment of principal that is due but unpaid, beginning with the earliest such installment. The number of days of lateness is based on the due date of the earliest loan installment that has not been fully paid. The MFI does not capitalize late or penalty interest payments.

PORTFOLIO QUALITY

	Outstanding principal balance	
	Portfolio at risk	**Amount**
Normal loans		
Current		850,924
1–30 days late	4.1%	40,713
31–90 days late	2.1%	20,967
91–180 days late	1.4%	14,026
More than 180 days late	0.9%	8,645
Subtotal	8.5%	935,275
Rescheduled and refinanced loans		
Current	3.8%	38,002
1–30 days late	0.8%	8,215
31–90 days late	0.4%	4,001
More than 90 days late	0.2%	1,172
Subtotal	5.3%	51,930
Total	13.8%	987,205

Loans more than 180 days late are automatically written off.

Loan terms are between three months and one year. Loan payments are scheduled weekly for loans shorter than six months. Longer loans are paid in monthly installments. Management estimates that the average term of its loan portfolio is about five months.

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

5.1 (continued)

treated as being late. The following list includes variables commonly used in the numerators and denominators of delinquency ratios, and indicates specific questions that must be answered if the variable is used. Beyond these questions, any other information needed to make the meaning of the ratio unambiguous should also be disclosed.

Numerator variables

- Outstanding balance of late loans for which one or more payments are due but unpaid, or number of active loans that are late. (At what point is the loan considered late? Does this balance include only principal, or interest as well?)
- Amount of late payments. (At what point is the loan considered late? Is "lateness" tied to missed payments or to the expiration of the loan term? Does the measure include principal, interest, or penalty interest?)
- Cash loan payments actually received during a period. (During what period? Does the measure include only principal, or interest as well? How are ➤*prepayments* and late payments treated?)

Denominator variables

- Total outstanding balance of active portfolio. (Does this number include capitalized interest—that is, interest payments that have been added to the principal of the loan?)
- Total number of active loans.
- Amount of payments due during a period. (Does the measure include principal, interest, or penalty interest? Are payments that fell due during an earlier period but remain unpaid included? Or does the measure include only payments that came due for the first time during the reporting period?)

It is recommended—but not required—that the term and payment structure of the MFI's loans be described: how long is the loan period, and at what intervals are payments scheduled? If the MFI's loans have varying terms or repayment schedules, then the average loan term can be reported (even if based on a rough estimate by management). Or, even more simply, a range can be given. This information may be useful in judging the riskiness of the reported level of delinquency. For instance, if 20 percent of loans are more than 30 days late, and the portfolio consists of three-month loans with weekly repayments, then the delinquency situation is very serious. But if the portfolio consists of two-year collateralized loans with monthly repayments, the situation may not be quite so worrisome.

Example 5.1 (B): Portfolio quality

The MFI measures loan delinquency using a current recovery ratio. The numerator of this ratio is total cash payments of principal and interest received during the reporting period (including prepayments and late payments). The denominator is total payments of principal and interest that fell due for the first time during the reporting period, under the terms of the original loan contracts (regardless of any subsequent loan renegotiations). Penalty interest is not included in the numerator or the denominator of the ratio.

Period	Current recovery ratio
January–December 1998	98.9%
1st quarter 1999	98.2%
2nd quarter 1999	99.1%
3rd quarter 1999	97.4%
4th quarter 1999	96.1%
January–December 1999	97.5%

All loans are paid in 13 weekly payments.[1]

Example 5.1 (C): Portfolio quality

The MFI measures portfolio quality using an arrears rate that divides the amount of overdue principal payments by the total gross outstanding portfolio (that is, outstanding principal without deduction of a loan loss reserve). Delinquent loans are not treated as overdue until 180 days after the last installment of the original loan term has fallen due.

	As of 31 December 1999	As of 31 December 1998
Total due but unpaid principal	125,052	42,545
Total gross outstanding portfolio	1,428,234	696,844
Arrears	8.7%	6.1%

Loans are for one year, payable in weekly installments.

[The inclusion of example C does NOT imply endorsement of the delinquency measure used.]

1. Despite a recovery rate that looks very high, this MFI would probably lose about 19 percent of its portfolio every year (see CGAP Occasional Paper 3, p. 8).

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

5.2 A portfolio report should clearly describe an MFI's approach to allowing, tracking, and provisioning for the ➤*renegotiation* of delinquent loans.

When a client is having trouble making timely payment on a loan, or is expected to have trouble, an MFI may permit renegotiation of the loan, including through ➤*rescheduling* (extending the term of the loan or relaxing the schedule of required payments) or ➤*refinancing* (paying off a problem loan by issuing a new loan).[7] In either case a new loan with a new payment plan is usually entered into the loan tracking system.

If renegotiated loans are not tracked separately, any indication of the client's payment problems will disappear, at least at first. If the client later misses payments, an arrears rate (delinquent payments divided by total portfolio) will strongly understate the MFI's risk. A delinquency report can be very misleading unless there is a description of the MFI's practices on renegotiation.

7. Sometimes loans are renegotiated (refinanced or rescheduled) for reasons other than the client's inability to pay the original loan on time. In these guidelines, however, renegotiation refers only to problem loans.

Example 5.2 (A): Renegotiated loans

Under exceptional circumstances, management may renegotiate loans—either refinancing the entire loan (issuing a new loan to pay off an existing one) or rescheduling repayment terms for clients who have suffered catastrophic events and who appear willing and able to repay their loans under longer-term agreements. Every renegotiation of a loan must be approved by a committee made up of the heads of the collections, credit, and internal control departments.

All renegotiated loans are treated as new loans and tracked separately from normal loans in the loan tracking system. Renegotiated loans are tracked separately because they have a higher risk profile than loans that have not been renegotiated.

	1999	**1998**
Rescheduled loans	1,443,224	
Refinanced loans	278,890	149,672
Normal loans	18,420,648	17,432,050
Total loans	20,142,762	17,581,722

Example 5.2 (B): Renegotiated loans

Loans are sometimes refinanced and rescheduled at the discretion of the branch manager. Such loans are not tracked separately, so the extent of such practices cannot be determined.

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

5.3 ➤*Insider loans*—whether to members of an MFI's management, governing body, or parties related to them—should be fully disclosed, including outstanding amounts, interest rates, collateral, and repayment status. Small loans generally available to all employees can be reported showing only the total amount, number, interest rate, and degree of late payment on such outstanding loans. Policies on both types of insider loans should be described precisely.

When persons with influence over an MFI's governance or management receive insider loans from the MFI, there is an inherent conflict of interest, creating a risk that loans may be made on terms that are not in the MFI's best interests. It is important to have detailed, transparent disclosure of such loans.

Some MFIs have loan programs for employees—for instance, to buy motorcycles or for personal emergencies. If numerous, these loans can be reported as a group because they present less risk and because reporting individual loans would be cumbersome.

The MFI's policies on both kinds of insider loans should be described.

Example 5.3 (A): Insider loans

The loan portfolio as of 31 December 1999 includes loans to the following related parties:

RELATED PARTY LOANS

Borrower	Principal balance outstanding	Loan term	Status
Board chairperson	500,000	24 months	Current
General manager	47,346	12 months	Current
Board member	32,000	4 months	Refinanced and current
Chief district planner	78,890	6 months	Refinanced and late
Staff loans	233,333	3–6 months	6 of 39 loans are late
Total	891,569		

Loans to board members and staff are uncollateralized, charge 17 percent annual interest on unpaid balances, and are for terms of three months to two years. These loans must be approved by the board of directors. When a loan is to a board member, that member cannot participate in discussion of or voting on the loan.

Example 5.3 (B): Insider loans

By charter, the MFI makes no loans to board members, staff, or their families.

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

6 Donations

6.1 Revenue from donations should be shown separately from income generated by an MFI's financial business, so that the profit or loss from operations can be determined.

Financial statements for MFIs that are nongovernmental organizations (NGOs) sometimes lump revenue from donations together with revenue from normal operations—that is, interest and fee income. Most MFIs cannot rely on such donations being repeated regularly over the long term. Thus, to appraise the MFI's long-term viability and capacity to grow without continuous infusions of donor funds, stakeholders need to know what the MFI's financial performance would look like without donations.

So, if donations are included in the income statement, the MFI's operational profit or loss (interest and fee income from normal operations minus the expenses of those operations) should be shown, and donations should be separated out as non-operational income, either in the income statement or in a note.

Example 6.1: Donations separated from business income

INCOME STATEMENT FOR 1 JANUARY TO 31 DECEMBER

	1999	1998
Income		
Financial income		
Interest and fees on loans	1,811,925	1,238,866
Interest from investments	55,093	37,550
Total financial income	1,867,018	1,276,416
Expenses		
Financial expenses		
Interest on debt	203,247	118,932
Interest on deposits	19,103	7,685
Provision for loan losses	50,761	38,310
Loans written off	1,219,835	
Administrative expenses		
Personnel expenses	724,733	660,005
Other administrative expenses	518,860	395,436
Total operating expenses	2,736,539	1,220,368
Net profit/(loss) from operations	(869,521)	56,048
Non-operating income and expenses		
Grants and donations	400,000	789,994
Other non-operating income	46,590	25,847
Other non-operating expenses	(88,571)	(25,847)
Total profit/(loss)	(511,502)	846,042

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

6 Donations

6.2 The source and amount of current period donations should be disclosed. If there have been no donations, there should be an explicit statement to that effect.

6.3 The method of accounting for donations should be explained.

Example 6.2 (A): Grants and donations received

	1999	1998
1. Donor R (for a new product development project)	400,000	
2. Foundation Q (not earmarked)		289,994
3. Donor M (for a computerized loan tracking system)		500,000
	400,000	789,994

1. In 1999 the MFI received a three-year grant of 400,000 from Donor R to support the design, testing, and taking to scale of a new microinsurance product.

2. In 1998 the MFI received an unearmarked grant of 289,994 from Foundation Q. This was the last installment in a series of annual grants by Foundation Q from the time the MFI began operations in 1993.

3. In 1998 the MFI received a grant of 500,000 from Donor M to support the implementation of a computerized loan tracking system.

Example 6.2 (B): Grants and donations received

The MFI received no grants or donations in 1998 or 1999.

Example 6.3 (A): Accounting for grants and donations

Grants and donations for operations and for loan funds to be used in the current operating period are recorded in the income statement, below the net income from operations. Grants and donations for periods beyond the current operating period are recorded under liabilities as deferred grants.

Grants for fixed assets are recorded as deferred revenue in the balance sheet and an amount equal to depreciation is transferred to income over the useful life of the assets acquired, in accordance with International Accounting Standard 20.

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

6.4 In-kind donations or subsidies should be disclosed, and there should be an estimate of the additional expense the MFI would incur in their absence.

MFIs often receive in-kind donations that are not recorded on their balance sheets or income statements. For instance, a donor may pay the salary of the MFI's executive director, the MFI may be occupying rent-free offices, or it may have free use of vehicles owned by international organizations. This practice is especially prevalent in international multiservice organizations that operate programs out of regional or country offices.

These goods or services may be important for the viability of the MFI's business, and the MFI may have to pay for them in the future, especially as it expands. Thus it is important to identify any such in-kind subsidies and estimate the additional expense the MFI would incur in their absence—even if the estimate is not based on a rigorous valuation.

Sometimes a donor provides in-kind assistance that the MFI would not use in the absence of the relationship with the donor—such as a consultant to conduct an impact study that is more for the donor's purposes than the MFI's. In such cases the assistance need not be reported as an in-kind donation. Similarly, a donor may contribute services, such as a foreign consultant or fixed assets, that the MFI could obtain less expensively on its own. In that case the in-kind donation should be reported, but the value assigned to it should be the amount the MFI would have to pay to get equivalent assistance, rather than what the donor paid.

6.5 The cumulative amount of all prior period donations for the MFI's financial operations should be shown. (This guideline is optional—while strongly recommended, it is not required.)

It is useful to have a list of the sources and amounts of cash donations for the MFI's financial operations for all previous periods, or at least the total amount of such donations. This information allows readers of financial statements to determine how much of the MFI's net worth came from donations and how much came from retained earnings or operational losses.

Such information will often imply large accumulated operational deficits that have been funded by donations. These deficits require careful interpretation, and are not necessarily a negative reflection on management performance.

Example 6.3 (B): Accounting for grants and donations

The MFI records unrestricted grants in the income statement in the period they are received. It records restricted grants as liabilities in the balance sheet and transfers specific amounts to income when restrictions end, in accordance with the requirements of Statement of Financial Accounting Standard 117.

Example 6.3 (C): Accounting for grants and donations

The MFI records all grants for operational expenses in the income statement below the net profit (loss). It transfers this amount to donated equity in the balance sheet on a memorandum basis. Capital grants for fixed assets and loan funds are recorded directly in the balance sheet as donated equity.

Example 6.4: In-kind donations

The MFI relies on services contributed in kind that are not recorded in its financial statements:

- Since September 1999 a consultant who is a staff member of Apex Organization H has served as Information Systems Adviser and provided technical assistance on the rollout of new management information system (MIS) software. Management's estimated fair market value for this service is 4,000 a month and totals 12,000 for 1999.
- Three branches operate out of offices that are provided rent-free by the municipality. Management's estimated fair market rent for similar space is 12,000 for 1999 and 11,500 for 1998.
- The regional representative of XXX International serves as director for both the MFI and XXX International. About 60 percent of his time is spent on the microfinance program. In his absence the MFI would have to hire a full-time director at an estimated cost of 40,000 a year.

Example 6.5: Cumulative donations

CUMULATIVE DONATIONS RECEIVED THROUGH 1998

1993	United Nations Capital Development Fund (direct operational support)	79,000
1993	Concern International (opening of two new regions)	450,000
1995	Fredonia International Development Agency (not earmarked)	576,550
1997	Hess Foundation (expansion of loan portfolio)	1,080,000
1998	Consultative Group to Assist the Poorest (not earmarked)	300,000
		2,485,550

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

7 Details of Liabilities

7.1 For all loans to an MFI that account for more than 10 percent of its total liabilities, the following information should be provided:

- **Source of the liability.**
- **Terms of the loan—amount, repayment schedule (including ➤*grace periods*), interest rate, and currency in which it is to be repaid.**
- **Guarantee mechanisms used to obtain the loan, including the percentage of the loan covered by the guarantee.**
- **Average outstanding principal balance of the liability during the reporting period, calculated on a monthly or at least quarterly basis.**
- **Interest expense during the reporting period, including cash payments and accruals.**
- **Full details of any arrears if the MFI has failed to make a payment when due during the period or is not current on the loan at the end of the reporting period.**

MFIs often receive debt funding at below-market interest rates. Because they cannot depend on being able to fund future growth with a continued flow of soft loans, it is important to know the extent to which an MFI is being subsidized through this mechanism. If interest amounts and rates are disclosed, it is possible to estimate how much more the MFI would have had to pay if the same loan were taken on commercial terms.

7.2 Any type of deposit account that is tied to clients' ability to obtain future microloans should be shown separately from other deposits, and there should be a general description of the conditions of the account and its linkage to loans.

Many MFIs use mandatory savings as part of their lending methodology: potential borrowers are required to deposit certain amounts before or during a loan. Such mandatory savings may reduce the MFI's risk on loans and almost always raise the client's effective cost for a loan. They are best viewed a part of the MFI's loan product. Voluntary savings, on the other hand, serve a very different purpose: clients make these deposits for their own liquidity management purposes.

If an MFI requires clients to make an equity investment—such as share capital in financial cooperatives—in order to access loans or other services, such capital should be shown separately and the requirement should be described.

Example 7.1: Debt funding

Debt as of 31 December 1999 and 1998 consisted of the following:

Organization X: loan principal of 1,350,000 drawn down in January 1993, payable in 40 quarterly installments beginning the first quarter after disbursement. The loan accrues interest at 3 percent a year, payable quarterly. Principal and interest are payable in U.S. dollars.

Year	Loan principal balance	Average annual balance (quarterly)	Annual interest expense
1999	405,000	472,500	14,681
1998	540,000	607,500	18,731

Bank Z: loan principal of 1,200,000 drawn down in January 1999, payable in 12 semiannual installments beginning one year after disbursement. The loan accrues interest at 14 percent a year, payable semiannually beginning six months after disbursement. Principal and interest are payable in local currency. The loan is secured by a 40,000 foreign currency deposit and a 50 percent guarantee on principal and interest by Donor Q.

One semiannual installment of 200,000 became due for repayment but has not been paid.

Year	Loan principal balance	Average annual balance (quarterly)	Annual interest expense
1999	1,200,000	1,200,000	168,000

Example 7.2: Contractually tied client deposits

All savings are placed in accounts that are tied to loan eligibility. The MFI requires all clients to establish a savings account with the MFI and to deposit at least 10 percent of the loan for which they applied. It further requires clients to make payments into this account equal to 5 percent of each amortization of principal and interest. Clients can withdraw these mandatory deposits only for group-approved emergencies, or upon withdrawing from membership in the MFI.

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

8 Other Significant Accounting Policies

8.1 **Accounting policies on the accrual or deferral of income or expense should be briefly explained.**

8.2 **There should be an indication of whether the MFI depreciates fixed assets, along with the methods used for such depreciation.**

Example 8.1 (A): Accounting methods

a. Basis of accounting

Financial statements are prepared on an accrual basis. Under this basis, transactions are recognized when they occur, not when cash is received or paid. As a conservative exception, interest income on loans is recorded on a cash basis—that is, when it is received in cash. At the end of the year, adjustments are made to accrue interest income on late but performing loans.

Example 8.1 (B): Accounting methods

a. Basis of accounting

Financial statements are prepared on a cash basis. Under this basis, transactions are recognized when cash is received or paid, not when they occur. Interest income on loans is collected and recorded in full at disbursement. At the end of the year, an adjustment is made to allocate interest collected in advance for the following period.

Example 8.2: Accounting estimates

Depreciation policy

Fixed assets are depreciated using the straight-line method, where an equal amount is amortized each period over the estimated useful life of the asset. Management sets the estimated useful life for each asset category and derives an annual depreciation rate using the table below.

Asset	Estimated useful life	Depreciation rate
Buildings	25 years	4%
Furniture and fittings	5 years	20%
Vehicles	4 years	25%
Computer equipment	3 years	33%

A full year's depreciation is charged in the year of acquisition and none in the year of disposal.

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

8.3 Any accounting policy that provides for, registers, or otherwise compensates for the effects of inflation on the MFI's financial situation should be briefly described, including an indication of which accounts are affected.

Most of a financial institution's assets and liabilities are denominated in units of currency. Inflation reduces the real value of the equity capital of such an institution. Where inflation is high, International Accounting Standards require the use of an inflation accounting method to reflect this real loss of value. High-inflation countries use different systems to reflect this loss, some of them legally prescribed and some voluntary.

Example 8.3 (A): Maintenance of value

Financial institutions in Bangladesh are not required to use inflation-based accounting methods. Nevertheless, the MFI generates a capital reserve representing the concept of maintenance of value. The maintenance of value adjustment to the net income generated by the MFI is calculated by multiplying net financial assets (equity-fixed assets) by the inflation rate. This "cost" reduces net income on the income statement, allowing the statement to represent real post-inflation profit. Because this cost represents funds that never actually leave the institution, they are accounted for in a separate capital reserve—the maintenance of value reserve. Thus the accumulated net income account on the balance sheet also represents real accumulated profits after the cost of inflation has been duly considered.

Example 8.3 (B): Maintenance of value

The MFI operates in an inflationary economy: the government estimates that inflation was 47 percent in 1999, 39 percent in 1998, and 35 percent in 1997. As a result the country requires the use of inflation-based accounting techniques. Management maintains accounts under the historical cost approach and restates financial statements at the end of each financial year.

In accordance with inflation accounting, management generates a maintenance of value expense on the income statement and a corresponding capital account on the balance sheet. The value of this account is derived at the close of each accounting period by multiplying the equity of the MFI at the end of the prior accounting period by the net change in the inflation index over the period. This value is considered a financial expense and reduces net profits. The MFI also realizes a gain from the revaluing of fixed assets that is netted out from the losses resulting from the equity calculations. The net result is also added to the accumulated inflation adjustment that appears on the balance sheet as a capital account.

In addition, the MFI restates historical values on its financial statements in current pesos. It restates all items in the income statement by applying the change in the general price index from the months when the items were initially recorded. It restates nonmonetary assets by applying a general price index and reduces restated assets to net realizable value.

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

8.4 MFIs with assets or liabilities denominated in a foreign currency should disclose any significant currency mismatch (➤*financial assets* balanced against liabilities denominated in a different currency).

If, for instance, an MFI borrows money denominated in foreign currency and makes loans in local currency, it is exposed to risk of substantial loss in the event of a depreciation of the local currency. If liabilities in foreign currency are not matched by assets in foreign currency, a currency mismatch or gap exists. A significant currency gap poses a risk to the MFI that needs to be disclosed.

8.5 The report should describe the accounting treatment of unrealized gains or losses due to foreign currency fluctuations.

When the local currency depreciates against foreign currency, the value of an MFI's foreign-currency–denominated liabilities will increase when expressed in local currency terms. The accounting method used to recognize this loss, or the absence of any such accounting method, should be disclosed.

Example 8.4: Currency analysis

Liabilities include long-term loans denominated in foreign currency. On the balance sheet, foreign currency liabilities are converted to local currency using the rate prevailing on the balance sheet date, to analyze foreign currency exposure.

The net foreign currency position as of 31 December 1999 shows a gap of 4,020,845 as follows:

Currency mismatch (expressed in local currency)	**Foreign currency items**	**Local currency items**	**Total**
Financial assets			
Loan portfolio		6,980,879	6,980,879
Investments	489,000	166,131	655,131
Financial liabilities			
Loans	(4,509,845)	(473,300)	(4,983,145)
Net foreign currency position	(4,020,845)	6,673,710	

Example 8.5: Currency fluctuations

Any gains or losses in the value of foreign currency liabilities from one balance sheet period to another resulting from changes in the exchange rate are recorded on the income statement in the account "Unrealized currency gains and losses" at the close of each period. Any gains or losses from foreign currency transactions are recorded in the income statement on the settlement date.

Humanitas loan	**Face value in pounds sterling**	**Prevailing exchange rate**	**Local currency book value**
14 February 1999	500,000	20.00	10,000,000
31 December 1999	500,000	22.50	11,250,000
Unrealized loss			(1,250,000)

Management recognizes the currency exposure and attempts to compensate for its currency risk when setting its interest rates.

These examples illustrate one way to present the information: there is no requirement to use the format shown here.

Annex A Glossary

Balance sheet. A summary of an institution's financial position at a given point in time. It presents the institution's stock of assets (such as cash, investments, loan portfolio, or fixed assets), liabilities (such as loans or accounts payable), and equity capital (net worth: the difference between assets and liabilities).

Cash-flow statement (sources and uses of funds). A summary of an institution's cash inflows and outflows during the reporting period.

Chart of accounts. A framework (list of account categories) that structures the classification and recording of accounting transactions.

Delinquency. Failure to make loan payments on time.

Financial assets (or liabilities). Cash held and assets or liabilities to be received or paid in fixed or determinable amounts of money. Cash, financial investments, and loan portfolio are financial assets. Buildings, land, and equipment are not.

Financial statements. A set of reports showing an institution's financial performance and position, typically containing a balance sheet, an income statement, and perhaps a cash-flow statement, along with explanatory notes.

Grace period. An initial period after the disbursement of a loan during which the borrower is not required to pay principal, or principal and interest.

Income statement (profit and loss statement, operations statement). A summary showing income, expenses, and net profit or loss (the difference between income and expenses) for a period of time—say, 1 January–31 December 2000.

In-kind donation or subsidy. Goods and services that an MFI uses in the conduct of its business but does not pay for because they are being provided by a donor or other third party.

Insider loans (related party loans). Loans made to a person in a position of influence within the lending institution, or to someone connected with such a person. Such loans raise conflict of interest issues.

*Loan loss provision expense.** An expense recorded in the income statement to reflect an increase in the probability of losses due to uncollected loans.

* The terms *provision* and *reserve* are sometimes used interchangeably. In this document *loan loss provision expense* is used only for an expense on the income statement, and *loan loss reserve* is used only for a balance sheet account.

*Loan loss reserve.** An amount set aside in the balance sheet to recognize probable future loan losses so that the true value of the loan portfolio is fairly stated. The reserve is increased by additional loan loss provision expense and reduced by write-offs of uncollectable loans.

Loan portfolio. The asset composed of the loans that borrowers owe to an MFI. The amount of the loan portfolio is the total unpaid principal balance of such loans.

Operational income, expense, profit, or loss. Stemming from an institution's core business—as opposed to non-operational items, such as donations, that are not produced by the business activity and that may not recur.

Opinion letter. A signed representation by an auditor attesting to the reliability and fairness of a set of financial statements. It is usually presented at the beginning of an audit report.

Outstanding. Remaining to be paid. An outstanding loan is a loan that has been disbursed but neither paid in full nor written off. Outstanding portfolio is the unpaid principal balance of all loans owed to the lender.

Prepayment. Payment of a loan in advance of the payment schedule in the loan contract.

*Refinancing.*** Paying off a client's problem loan by issuing a new loan to the client, often with fresh money disbursed, capitalization of the unpaid interest on the prior loan, or both.

*Renegotiation.*** Changing the terms of a loan in response to a client's inability to pay it on time. Refinancing and rescheduling are the most common forms of renegotiation.

*Rescheduling.*** Extending or otherwise easing the payment schedule of a problem loan by amending the original loan contract.

Segment reporting. Reporting that separates the financial results of two or more distinct activities or lines of business conducted by a single institution.

Soft loan. A loan, typically from a donor or government, with a lower interest rate than an MFI could have obtained from commercial sources.

Write-off. The elimination of an uncollectable loan amount from the loan portfolio in the balance sheet.

** Sometimes loans are renegotiated (refinanced or rescheduled) for reasons other than the client's inability to pay the original loan on time. In these guidelines, however, renegotiation refers only to problem loans.

B Annex Black-letter Version of the Guidelines

1. Financial Statements

1.1 At a minimum, MFI financial statements should include both a balance sheet and an income (profit and loss) statement, with accompanying notes.

2. Information from Past Years

2.1 Statements should show financial information for both the current year and at least the previous year, and include a comment on any unusual movements.

3. Segment Reporting for Multiservice Microfinance Institutions

3.1 An MFI that offers both financial and nonfinancial services should provide a separate income statement for the financial service business (in addition to a consolidated income statement and balance sheet for the institution as a whole).

3.2 There should be a clear explanation of the methods used to allocate shared costs or revenues between financial and nonfinancial services.

3.3 There should be a clear identification of which accounts in the balance sheet of a multiservice MFI are tied to microfinance services.

4. Microloan Portfolio Accounting Issues

4.1 Expenses related to actual or anticipated loan losses should be shown separately from other expenses in the income statement. The accounting policy underlying the recognition and amount of such loan loss expenses should be clearly described.

4.2 The amount of the loan loss reserve should be shown, usually as a negative asset deducted from the loan portfolio or as a reserve in the capital account. The accounting policy underlying the determination of this reserve should be clearly described.

4.3 The amount of loans written off during the period must be shown. The policy governing the amount written off should be stated clearly and in detail, including how other accounts are affected by the write-off.

4.4 The financial presentation should include a table that reconciles the accounts affecting the loan portfolio, including:

- Loan loss reserves at the beginning and end of the period.
- Loan loss provision expenses recognized during the period.
- Write-offs of uncollectable loans.

4.5 If an MFI accrues unpaid interest on late loans, there should be a clear and thorough explanation of its policies on this matter—especially the point at which further accrual of unpaid interest is stopped and previous accruals are reversed out of income.

5. Portfolio Quality and Management

5.1 A portfolio report should show the extent of late payment on loans as of the end of the current reporting period, and any measurement of late payment should be thoroughly explained—including precise definitions of the numerator and the denominator of any ratio measuring loan portfolio quality.

5.2 A portfolio report should clearly describe an MFI's approach to allowing, tracking, and provisioning for the renegotiation of delinquent loans.

5.3 Insider loans—whether to members of an MFI's management, governing body, or parties related to them—should be fully disclosed, including outstanding amounts, interest rates, collateral, and repayment status. Small loans generally available to all employees can be reported showing only the total amount, number, interest rate, and degree of late payment on such outstanding loans. Policies on both types of insider loans should be described precisely.

6. Donations

6.1 Revenue from donations should be shown separately from income generated by an MFI's financial business, so that the profit or loss from operations can be determined.

6.2 The source and amount of current period donations should be disclosed. If there have been no donations, there should be an explicit statement to that effect.

6.3 The method of accounting for donations should be explained.

6.4 In-kind donations or subsidies should be disclosed, and there should be an estimate of the additional expense the MFI would incur in their absence.

6.5 The cumulative amount of all prior period donations for the MFI's financial operations should be shown. (This guideline is optional—while strongly recommended, it is not required.)

7. Details of Liabilities

7.1 For all loans to an MFI that account for more than 10 percent of its total liabilities, the following information should be provided:
- Source of the liability.
- Terms of the loan—amount, repayment schedule (including grace periods), interest rate, and currency in which it is to be repaid.
- Guarantee mechanisms used to obtain the loan, including the percentage of the loan covered by the guarantee.
- Average outstanding principal balance of the liability during the reporting period, calculated on a monthly or at least quarterly basis.
- Interest expense during the reporting period, including cash payments and accruals.
- Full details of any arrears if the MFI has failed to make a payment when due during the period or is not current on the loan at the end of the reporting period.

7.2 Any type of deposit account that is tied to clients' ability to obtain future microloans should be shown separately from other deposits, and there should be a general description of the conditions of the account and its linkage to loans.

8. Other Significant Accounting Policies

8.1 Accounting policies on the accrual or deferral of income or expense should be briefly explained.

8.2 There should be an indication of whether the MFI depreciates fixed assets, along with the methods used for such depreciation.

8.3 Any accounting policy that provides for, registers, or otherwise compensates for the effects of inflation on the MFI's financial situation should be briefly described, including an indication of which accounts are affected.

8.4 MFIs with assets or liabilities denominated in a foreign currency should disclose any significant currency mismatch (financial assets balanced against liabilities denominated in a different currency).

8.5 The report should describe the accounting treatment of unrealized gains or losses due to foreign currency fluctuations.

C Annex Form for Comments on the Guidelines

If you use these guidelines in preparing audited or unaudited financial statements any time before 31 July 2001, please consider sending CGAP a copy of these statements, along with comments about your experience in applying the guidelines. Revising and improving this publication will be possible only with widespread field input. Please answer the following questions in as much detail as your time and generosity allow.

Send the completed form, along with the financial statements prepared using the guidelines, to Patricia Mwangi, CGAP Secretariat, Room Q4-119, World Bank, 1818 H Street N.W., Washington, D.C. 20433, USA; fax: +01 202-522-3744; email: pmwangi1@worldbank.org

CGAP guarantees the confidentiality of your financial statements and comments. They will be seen only by the staff validating the guidelines, and will then be destroyed. The information will not be used for any other purpose.

Name of sender:

Institution:

Postal address:

Email:

Fax:

1. Which parts of the text or the examples did you find unclear?

2. Which of the guidelines did you find difficult to apply? Why?

3. What changes would you suggest?

4. Do you have any other comments?